

THE CHARTERED INSTITUTE OF TAXATION

APPLICATION AND PROFESSIONAL SKILLS

VAT and Other Indirect Taxes

November 2022

TIME ALLOWED

3 HOURS 30 MINUTES

- In order to secure a pass in this exam, you will be required to demonstrate competence in each of three skills.

You will be assessed across your answer as a whole for Structure. A pass or fail grade will be awarded.

You will be assessed for competence in a number of broad topics for the following skills:

- Identification and Application
- Relevant Advice and Substantiated Conclusions

For each topic for each of these two skills, a grade will be awarded. The grades for those topics will be weighted and averaged to produce a final grade for each skill of 0, 1, 2, 3 or 4. A grade of 3 or 4 is required to demonstrate competence.

- All workings should be shown and made to the nearest month and pound unless the question specifies otherwise.
- Candidates who answer any law elements in this paper in accordance with Scots law or Northern Ireland law should indicate this where relevant.
- Scots law candidates may provide answers referring to Land and Buildings Transaction Tax rather than Stamp Duty Land Tax.
- Unless otherwise indicated by the provision of additional information in the question, you may assume that 2021/22 legislation (including rates and allowances) continues to apply for 2022/23 and future years. Candidates answering by reference to more recently enacted legislation or tax cases will not be penalised.
- You must type your answer in the space on the screen as indicated by the Exam4 guidance.

You are a Chartered Tax Adviser who has received a letter (**EXHIBIT A**) from long-standing clients of the firm, Robin and Maureen Knight and Naomi Knight-Day. They are seeking advice in relation to the VAT and other tax implications arising on the proposed rebuilding of a property, Marandellas House (“the House”), which was extensively damaged by a fire on 26 December 2021.

The following exhibits are provided to assist you:

EXHIBIT A: Letter from Robin and Maureen Knight and Naomi Knight-Day

EXHIBIT B: Marandellas House – projected cost of rebuilding

EXHIBIT C: Lease Extract

EXHIBIT D: Pre-seen information

Requirement:

Write a letter to Robin, Maureen and Naomi providing them with advice and recommendations in relation to the works on Marandellas House and the structure for its ownership.

Continued

EXHIBIT A

Letter from Robin and Maureen Knight and Naomi Knight-Day

T Adviser
Owen, Laidlaw & Partners
The Counting House
100 Eastgate
Tolmach
TR2 4TT

1 November 2022

Dear Adviser

Marandellas House ("the House")

Further to our discussion last week, we are writing as the leaseholders of the flats within the House to seek your advice and recommendations on the proposed rebuilding project. As you are aware, the House is a listed manor house situated at St Jude's Bay, Loamshire comprising four self-contained flats (two flats situated on each of the two floors).

In March 2005, for Inheritance Tax planning purposes, our parents (now deceased) created 125-year leases in respect of each flat. The leases to flats 3 and 4 on the upper-floor were gifted to Naomi, with the leases to flats 1 and 2 on the ground-floor gifted jointly to Robin and Maureen (hereafter we refer to the lessees as "the family members"). For Capital Gains Tax, the value of the interests transferred was agreed at £85,000 for each flat. The grant of the leases was exempted from VAT.

Also in March 2005, our parents incorporated JW Knight Ltd ("the Company") and transferred their farming and other business activities into it, in addition to the freehold of the House (including, for the avoidance of doubt, its reversionary interests in the House's common parts and grounds). Following their parents' deaths, Naomi and Robin each now hold 35% of the Company's issued share capital. The remaining shares are held by the Managing Director, Raymond Reeve, and his fellow directors, who are not related to the family members. The Company is VAT registered due to its farming and business activities.

Family members and their friends use the flats rent free for approximately 20% of the year. When not reserved by family members, they are let as furnished holiday accommodation through an agent, with each flat generating up to £1,000 (gross of associated costs) a week in peak periods.

The House was extensively damaged by fire in December 2021. The external walls of the House, along with some internal walls, remain standing, albeit fire damaged. The planning authority has said that these walls must be retained when reinstating the property. The pre-fire configuration of the House will be largely retained. The planning authority has approved the proposed works, with no restriction on the use or disposal of the reinstated flats.

The total cost of reinstating (including fitting-out the kitchens and bathrooms, fixtures and fittings, etc.) is estimated at £5.7 million, inclusive of VAT at the standard rate. A breakdown of the estimated costs is enclosed (**EXHIBIT B**).

Work is to be carried out in two Phases. Phase 1 will start in February 2023, with completion scheduled for December 2023, comprising re-roofing the property, the replacement of beams to preserve the integrity of the remaining internal and external walls, repairs to the external stonework and the replacement of windows and doors. Phase 2 will commence in January 2024, with the works substantially concerned with the internal works of reinstating and fitting out the flats and common parts, scheduled to be completed in August 2025.

The agreed portion of the costs to be borne by the Company is £720,000, inclusive of VAT, of which £480,000 relates to the Phase 1 works, with £240,000 allocated to reinstatement of the internal common parts (Phase 2 works).

We are considering this may be an opportunity to reconfigure the flats by adding a bedroom to one of the flats on each floor, with a corresponding reduction in the size of the adjacent flat. The planners are content to vary the current consent. We have been advised that this would not materially affect the projected costs' estimate, but may afford some VAT relief?

Continued

The position in respect of the insurance of the property is set out in the enclosed extract of the Lease (**EXHIBIT C**).

In relation to the damage caused by the fire, the Company's insurers will cover the entirety of its costs. Unfortunately, however, the family members' interests were under-insured, and the insurer will only meet £4 million of their costs (including irrecoverable VAT). This leaves a shortfall on estimated rebuilding costs of £980,000. Naomi will bear one half, with Robin and Maureen meeting the balance jointly. The current value of each leasehold flat in its damaged condition is £125,000, with its market value prior to the fire being £650,000 (the properties were in desperate need of modernisation).

For practical reasons and to mitigate the cost of the works, the Company and the family members will jointly engage the contractor and professional consultants for both Phase 1 and 2. On completion of the works, the family members will continue to let the flats as furnished holiday accommodation.

The shortfall contributions required from family members are significant and need to be reduced. Accordingly, we require your advice and recommendations on the tax and commercial implications of the above and on a possible alternative structure set out below which would involve the Company undertaking the works.

The alternative structure would involve family members surrendering the leasehold flats in their current condition to the Company in exchange for shares. Accordingly, Naomi would receive 250,000 ordinary £1 shares, and Maureen and Robin would receive 125,000 ordinary £1 shares each (the Company will need to issue new shares to accommodate this). The family members would assign the benefits of the insurance moneys to the Company for the sole purpose of completing the reinstatement works. On completion of the restoration, the Company would not grant new leases to the family members. Instead, it would let the flats as furnished holiday accommodation, subject to offering the family members the use of them free of charge for four weeks in July/August. This alternative structure would enable the Company to undertake the works from its reserves together with the insurance receipts; and make the structure simpler in that the freehold and leasehold interests would merge. Most importantly however, it would avoid the family members having to fund the shortfall.

Your advice and recommendations should focus on the interests of the family members in their capacity as leaseholders. The advice will be passed to the Company's management team, which may independently seek advice from your Corporation Tax colleagues. All parties are content that the firm's existing procedures will avoid a conflict of interest. We look forward to receiving your advice and recommendations.

Yours sincerely

Robin Knight QC
Maureen Knight
Naomi Knight-Day

Continued

EXHIBIT BMarandellas House – projected cost of rebuilding

	<u>Family</u>	<u>Company</u>	<u>Total</u>
	£	£	£
Phase 1 (net of VAT):			
Building costs	540,000	360,000	900,000
Professional services	60,000	40,000	100,000
Total, excluding VAT	<u>600,000</u>	<u>400,000</u>	<u>1,000,000</u>
Phase 2 (net of VAT):			
Building costs	3,195,000	180,000	3,375,000
Professional services	355,000	20,000	375,000
Total excluding VAT	<u>3,550,000</u>	<u>200,000</u>	<u>3,750,000</u>
VAT (20%)			
Phase 1	120,000	80,000	200,000
Phase 2	710,000	40,000	750,000
Total VAT cost	<u>830,000</u>	<u>120,000</u>	<u>950,000</u>
Total projected cost, including VAT	£4,980,000	£720,000	£5,700,000
Insurer's contribution	<u>(4,000,000)</u>	<u>(720,000)</u>	<u>(4,720,000)</u>
Net shortfall	<u>£980,000</u>	-	<u>£980,000</u>

Continued

EXHIBIT C

Lease Extract

Insurance

In addition to their contents, the Family Members are required to insure the House (including that part of the freehold relating to their leasehold interest but excluding common areas) against damage occasioned by fire and other risks; with the Company's reversionary interest in the flats noted in the policy. The cost of such insurance shall be apportioned between the Family Members in accordance with the floor area of their respective leasehold interests. Insurance claims met by the leaseholders' insurer are to be applied to the reinstatement of the property.

The Company shall be liable to insure the common areas and grounds of the House retained by the Company as freeholder, together with other parts of property in which it has an interest. Insurance claims met by the Company's insurer are to be applied to the reinstatement of the property.

Continued

EXHIBIT D

Pre-seen information

Clients

Robin and Maureen Knight
Naomi Knight-Day

Robin and Maureen Knight

Address

11 Wavell Mews,
Erle
ER23 2LL

Date of birth

Robin – 12 March 1976
Maureen – 26 May 1976

Marital status

Married. 25 July 2001

Children

Ralf (date of birth: 22 August 2004)
Katherine (date of birth: 18 December 2007)
Simon (date of birth: 2 February 2010)

Sources of income

Earned Income

Robin – Self-employment as a barrister and as an editor/author of a professional publication.
Maureen – Employee of a charity, Poverty Abroad.

Dividend Income - Robin

From JW Knight Ltd, the family firm.

Letting Income

Robin and Maureen have a joint leasehold interest in flats 1 and 2 in Marandellas House, which are used as furnished holiday lets. The average total annual gross income is £64,000 (earned evenly across the year) and the net income is £46,000 (split equally between Robin and Maureen).

Income Tax

Robin and Maureen are both higher rate taxpayers.

VAT

Robin is registered under number 987 6543 21 with effect from 1 April 2001 on account of his earnings as a barrister and author.

Continued

Continuation

Naomi Knight-Day

Address

26 High Street
Eastly
Hants
HW10 4BB

Date of birth

12 June 1978

Marital status

Married. Janice Day (24 June 2021)

Children

None

Sources of income

Earned Income

Managing director, Madisons Fine Art Dealers, London.

Dividend Income

From JW Knight Ltd, the family firm.

Letting Income

Naomi has a leasehold interest in flats 3 and 4 in Marandellas House, which are used as furnished holiday lets. The average total annual gross income is £60,000 (earned evenly across the year) and the net income is £44,000.

Income Tax

Naomi is a higher rate taxpayer.

JW Knight Ltd

<u>Shareholders</u>	<u>Ordinary Shares of £1 each</u>
Robin Knight	350,000
Naomi Knight-Day	350,000
Raymond Reeve	150,000
Simon Jackson	80,000
Mary Francis	70,000
	<u>1,000,000</u>

Directors

Raymond Reeve	Managing Director
Simon Jackson	Property Director
Mary Francis	Finance Director
Robin Knight	Non-executive Director
Naomi Knight-Day	Non-executive Director

Continued

Business

Principal activities of the company are:

- 1) Arable farming (3,500 acres) and livestock (cattle and pigs), Bottoms End, Gloucestershire.
- 2) Leasing of, and dealing in commercial property and warehousing space, principally Bristol and M4 corridor.

VAT

Registered under number 123 4567 89 with effect from 1 March 2005. The company is a partly exempt trader, with non-attributable input tax apportioned in accordance with the standard method. It has not opted to tax any of its properties.

Summarised Income Statement

	<u>30 June 2020</u>		<u>30 June 2019</u>	
	£'000	£'000	£'000	£'000
Farming activities:				
Turnover	16,300		14,670	
Cost of sales	<u>(13,680)</u>		<u>(11,630)</u>	
		2,620		3,040
Property investment:				
Rents and service charges	1,250		1,200	
Direct property expenses	<u>(950)</u>		<u>(880)</u>	
		300		320
Gross profit		2,920		3,360
Administrative expenses		<u>(2,310)</u>		<u>(2,150)</u>
Operating income		610		1,210
Other income		30		45
		640		1,255
Interest payable		<u>(30)</u>		<u>(215)</u>
Profit before taxation		610		1,040
Tax on chargeable profits at 19%		<u>(50)</u>		<u>(155)</u>
Profit for the financial year		<u>£560</u>		<u>£885</u>
Dividends paid		<u>£250</u>		<u>£300</u>

Summarised balance sheet

	<u>30 June 2020</u>		<u>30 June 2019</u>	
	£'000	£'000	£'000	£'000
Fixed assets:				
Freehold land and buildings	16,230		15,980	
Investment properties	1,050		1,025	
Plant and machinery	<u>1,625</u>		<u>1,435</u>	
		18,905		18,440
Current assets:				
Stock and cultivations	4,010		3,550	
Debtors	2,800		3,400	
Cash	<u>340</u>		<u>220</u>	
		7,150		7,170
<u>Net current assets</u>		<u>26,055</u>		<u>25,610</u>
Creditors:				
Amounts falling due after one year	5,035		4,920	
Amounts falling due in next 12 months	825		935	
Deferred tax	<u>1,235</u>		<u>1,105</u>	
		<u>(7,095)</u>		<u>(6,960)</u>
<u>Net assets</u>		<u>£18,960</u>		<u>£18,650</u>
Capital and reserves				
Called up share capital		1,000		1,000
Profit and loss account		<u>17,960</u>		<u>17,650</u>
Total shareholders' fund		<u>£18,960</u>		<u>£18,650</u>